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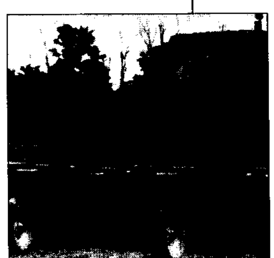

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PAYING FOR

CAN GREEN TAXES PROTECT THE ENVIRONMENT WHILE BOOSTING THE ECONOMY?

By Jonathan Marshall

ARTHUR MATSON

Who says there's no such thing as a free lunch? Not Vice President Gore, deputy budget director Alice Rivlin, or President Clinton's favorite think tank, the Progressive Policy Institute. They and other influential Washington policy wonks are touting a miracle cure for the economy's woes, one they claim will simultaneously boost productivity, help tame the deficit, and protect the environment.

Their secret weapon: a variant on supply-side tax reform. Shifting the tax burden away from economic "goods," such as labor and capital, onto economic "bads," such as harmful pollution, will allow individual welfare to flourish as never before, they

have asserted in a flurry of recent position papers.

Long vulnerable to the charge of ignoring economic realities in favor of Edenic fantasies, environmentalists are signing up right and left to endorse this theory. So are deficit fighters who spot a huge new source of revenue. With support growing fast within the Clinton camp, the day may not be far off when the country puts these claims to the test—much to the chagrin of some fiscal conservatives, who fear another tax-and-spend boondoggle in the making.

"The signs are certainly right for a carbon tax or broad-based energy tax," says Rep. Pete Stark, a liberal California Democrat who sits on the Ways and Means Committee and has introduced carbon-tax proposals in each of the past two sessions of Congress. "These taxes can achieve the new administration's goals of dealing with global warming, reducing the deficit, and increasing industrial competitiveness."

But this bandwagon is moving altogether too fast for some critics. Pollution-tax schemes "look a lot better than they turn out to be in practice," warns Fred Smith, president of the Competitive Enterprise Institute in Washington and a former policy analyst with the Environmental Protection Agency. Enormous uncertainties about the proper level of such taxes make it possible, if not probable, that Congress will botch the tax rates and leave the economy worse off than before. And powerful interest groups will lobby for spending the vast sums raised by pollution levies on pork-barrel projects, undercutting the theory behind this tax reform. What looks splendid on paper to academic economists may become a nightmare in practice for business and consumers.

Pollution taxes are an old idea. The economist A. C. Pigou proposed them more than half a century ago as a means of correcting the "externalities," or social costs, imposed by polluting industries. Several European nations, including France and Germany, have long levied charges on industrial effluent. The concept has been revived in the United States since the Reagan and Bush administrations began touting market-based approaches to environmental protection, including tradable "permits" for sulfur-dioxide and other harmful air emissions. Pollution taxes won bipartisan support in the "Project '88" study of environmental incentives led by Sens. Tim Wirth, a Colorado Democrat, and John Heinz, the late Republican from Pennsylvania.

The tax idea has never won favor with industry, for a simple reason: Polluters would rather protect and profit from rights to maintain their existing emissions through a tradable-permits scheme than pay taxes on their unwelcome output.

WHAT LOOKS SPLENDID ON PAPER TO ACADEMIC ECONOMISTS MAY BECOME A NIGHTMARE IN PRACTICE FOR BUSINESS AND CONSUMERS.

But the broad appeal of pollution taxes keeps the concept alive. In theory, pollution taxes should not only discourage harmful emissions and encourage cleaner production methods more efficiently than "one-size-fits-all" regulations, they also have the potential for raising tens or hundreds of billions of dollars, either for wiping out the deficit or for offsetting other, less desirable taxes.

The first of many salvos following Clinton's victory came in a major report issued in November by the Washington-based World Resources Institute, titled "Green Taxes: How a Tax Shift Can Work for the Environment and the Economy." WRI, a leading advocate of tougher fuel-economy regulations on new cars, has never been known as a champion of market-based thinking. But this report, advocating as much as $150 billion in new taxes on everything from toxic emissions and pesticide use to road congestion, demonstrates a high degree of economic sophistication along with an ambitious policy agenda.

If price incentives replaced traditional command-and-control regulations, the study argues, the current $120-billion annual cost of complying with environmental laws "could be halved." Road tolls, long advocated by free-market thinkers, could dramatically cut the 1.5 billion hours lost annually in traffic gridlock. Pay-by-the-bag fees for household waste, instead of the usual flat charge for garbage disposal, would motivate people to consume less wasteful packaging and recycle without costly mandates. Taxing fossil fuels according to their carbon content would encourage alternative energy sources less likely to aggravate the greenhouse effect.

And best of all, "Shifting 10 to 15 percent of the nation's tax burden from 'goods' onto 'bads' could yield an annual economic dividend greater than one percent of the Gross Domestic Product." This sum, it points out, "is as large as the much-heralded peace dividend."

Other organizations also chimed in. In December, the National Commission on the Environment, a private group convened by the World Wildlife Fund, offered up its own blueprint for a "sustainable future," which argued that "sending the right economic signals—with prices reflecting environmental consequences—is the most efficient way to achieve economic protection." The commission—including Rivlin, now deputy budget director, and three prominent members of Clinton's transition team—said that higher gasoline and carbon

taxes could promote energy efficiency and put America "on an energy path consistent with sustainable development."

Not to be outdone, the Progressive Policy Institute—the think-tank arm of the centrist Democratic Leadership Council, which Clinton chaired from 1990 to 1991—made pollution taxes a prominent part of its much-heralded manifesto, *Mandate for Change*. Released in December, it declares, "The progressive challenge for environmentalists in the 1990s is to harness the power of markets, which can be more effective and far-reaching than centralized regulation." Government regulations, it asserts, often "hamper innovation in pollution control methods" and "ignore important differences among individuals, firms and markets." Pollution taxes, by contrast, "give firms and individuals direct and daily interest" in protecting the environment, offer maximum flexibility in how to achieve that goal, and can replace other, less efficient taxes.

Die-hard environmentalists aren't the only advocates of hefty pollution taxes. Independent economists have also promoted pollution taxes as an efficient means of increasing net social welfare. In one recent study, Charles Ballard and Steven Medema at Michigan State University modeled the effects of different kinds of taxes on the economy and found, as expected, that traditional levies on labor and capital income reduce total production of goods and services by penalizing hard work and investment. (Typical estimates in the literature range up to 30 or 40 cents in economic losses for every additional dollar in taxes raised.) Pollution taxes, they found to the contrary, can boost total output by making businesses and consumers factor true social costs into their decisions.

"All the usual taxes—payroll, income, and corporate—mess things up," says Ballard. "They make people make the wrong work choices and savings choices. A tax designed to attack pollution is the best of all possible worlds. You've raised the money necessary to finance the government and in so doing made the private economy work better."

While others talk theory, W. Kip Viscusi at Duke University has tried to estimate actual numbers for potential pollution taxes. In a recent study for the EPA, Viscusi and some colleagues took the agency's scientific findings on the health effects of various pollutants, from deadly particulates to toxic chemicals such as benzene, and used them to estimate the social costs of various fuels that emit those pollutants, using standard formulas for the dollar "value" of human lives, hospital stays, and the like. (They did not include more-controversial estimates, pushed by some environmentalists, of the values of "national security," unobscured views, wildlife, and pristine ecosystems.)

They found that existing taxes on coal, gasoline, natural gas, and other fuels bear little relation to official midpoint estimates of their full health costs. Natural gas is priced about six times higher than it should be; coal, on the other hand, ought to be taxed about 15 times more than it is. Fuel wood, a source of particulates when burned, deserves stiff taxes as well—even if it is a politically correct "renewable resource." Gasoline taxes turn out to be almost right on the money, contrary to the confident claims of Ross Perot–style deficit fighters and environmentalists who advocate socking it to drivers. Cumulatively, true social-cost pricing of all energy sources would raise about $150 billion in new tax revenues, or more than $1,500 per household, Viscusi calculates.

At the same time, he stresses that these "best" estimates could be way off. Although scientists have spent years studying the health and environmental effects of such conventional pollutants, "the uncertainties are enormous," Viscusi says. The low estimate of the harm caused by coal burning comes to 21 percent of its market price; the high estimate reaches 1,035 percent. "That's a pretty big spread," Viscusi says. "If the lower bound is right, we don't have to do anything. If the upper bound is right, we need to crank up taxes by a factor of 30."

This is not a minor issue, he concedes. Getting the numbers wrong on these relatively straightforward pollution taxes may "involve both enormous social costs and substantial regret as well."

But Viscusi, unlike laissez-faire advocates, does not advocate abandoning the quest for pollution taxes. Instead, he says, these uncertainties argue for more and better research. "The existence of uncertainty per se shouldn't be a barrier to doing something," he says. "On the other hand, where we can resolve it quickly, there are potentially large gains from learning a lot quickly."

A $100-PER-TON TAX ON CARBON EMISSIONS COULD COST THE COUNTRY 2 PERCENT OF GROSS DOMESTIC PRODUCT.

The importance of getting matters right is clear enough from Viscusi's $150-billion tax estimate. Carbon taxes, endorsed by Gore and many environmentalists, could be just as hefty. A $100-per-ton tax on carbon emissions, for example, would boost the cost of a barrel of oil 73 percent, hike the price of gasoline 20 cents a gal-

lon, and add 27 percent to electric bills, according to the Department of Energy—and by some estimates cost the country 2 percent of gross domestic product, equal to more than $100 billion a year in today's economy.

Unless phased in over many years, energy taxes of these magnitudes could drag the economy into recession or ignite runaway inflation, much as the oil price jumps of the 1970s did. "You are talking a walloping effect if you impose these taxes all at once," says Viscusi.

Whether the gain will outweigh the pain is still a matter of dispute, particularly with respect to carbon taxes. Even economists friendly to the idea question whether the promised free lunch will really materialize. Lawrence Goulder at Stanford University finds that carbon taxes are less efficient even than labor or capital taxes because they fall on a smaller portion of the economy and thus create greater distortions. "Recycling" the proceeds of carbon taxes by lowering marginal tax rates on labor and capital would mitigate, but not eliminate, the huge cost of this environmental charge.

Goulder explains: "I was hoping I would get a strong result for the carbon tax dividend—that there would be less growth distortion from a carbon tax than from the taxes it would displace. I didn't get that result. What it means is you need to invoke associated environmental benefits to justify a carbon tax."

Unfortunately, as Goulder also notes, those benefits are largely unknown. "We've pretty much ignored the benefits side of the ledger. That raises the question of how big a carbon tax we want. The uncertainties are much greater than on the cost side."

The uncertainties on the cost side are big enough. Estimates of the impact of a carbon tax range from a slight positive to a loss of 5 percent of GDP annually, depending on assumptions about the emissions goal, the size of the tax assumed necessary to achieve it, how the proceeds of the tax would be distributed, what the path of economic growth would be absent a tax, and to what extent energy and capital are substitutes.

And as Goulder indicates, the uncertainties on the benefits side are even greater. Consensus estimates as to the degree of global warming likely from a doubling of greenhouse gases vary 300 percent, with some scientists (such as MIT's Richard Lindzen) questioning whether climate feedback mechanisms will permit any significant warming at all. As the Intergovernmental Panel on Climate Change confessed in its 1990 report, "There are many uncertainties in our predictions, particularly with regard to the timing, magnitude and regional patterns of climate change..."

If the global effects are largely unknown, national ones are even more a matter of guesswork. Some local changes could be amenable to cheap remedies, others could be catastrophic. And, as Robert Balling Jr., director of the Office of Climatology at Arizona State University, observes, "There could be any number of benefits," including faster plant growth stimulated by more carbon dioxide and precipitation.

These are not trivial unknowns when it comes to designing carbon taxes. "We find that costs rise very rapidly (with higher tax levels), so it is imperative that policy makers carefully assess the benefits of carbon dioxide abatement before adopting a particular [emissions] target," write Harvard University's Dale Jorgenson and Peter Wilcoxen at the University of Texas.

Given the unknowns, some specialists question whether carbon taxes are an answer to either environmental or fiscal problems. "The range of speculations about potential damages from carbon emissions is far too wide to be useful in setting carbon taxes," says W. David Montgomery, author of a 1990 carbon-tax study for the Congressional Budget Office.

Carbon taxes have other unique problems. In an essay last year in the *American Economic Review*, Thomas Schelling, an economist at the University of Maryland and former president of the American Economic Association, notes that the costs of global warming will fall disproportionately on the poorer nations, whose economies are less flexible and more tied to agriculture than those of the developed world. They might not thank us for curbing our own growth and resources in the name of helping them, he argues. "[It] would be hard to make the case that the countries we now perceive as vulnerable would be better off 50 or 75 years from now if 10 or 20 trillions of dollars had been invested in carbon abatement rather than in [aiding their] economic development."

ECONOMISTS ALSO POINT OUT THAT A U.S. TAX ON CARBON WILL DO LITTLE OR NOTHING BY ITSELF TO CONTROL GLOBAL WARMING.

Economists also point out that a U.S. tax on carbon will do little or nothing by itself to control global warming. As the poorer nations grow, their rising output of greenhouse gases will swamp any self-restraint on the part of the United States. As Montgomery's 1990 report for the Congressional Budget Office said, "If the United States unilaterally imposed a charge of $100 per ton, it might delay the doubling of carbon dioxide concentrations by only a few years, while a charge of that amount imposed by all countries might buy almost two decades."

If some economists are skeptical, many fiscal conservatives and libertarians are downright hostile to pollution taxes as a Trojan Horse for bigger government. Given the overwhelmingly liberal origin of recent pollution-tax schemes, their fears may not be farfetched.

Ray Cordato, an economist at the Institute for Research on the Economics of Taxation in Washington, has warned that "political considerations, not economics, dictate the imposition of these taxes. The most likely outcome of levying a pollution tax is the same as that of any other tax. There will simply be a transfer of resource claims from the private to the public sector and a reduction in efficiency and economic growth."

The Competitive Enterprise Institute's Fred Smith argues that the notion of "social cost" embedded in pollution taxes abstracts from the fact that specific individuals bear specific costs and should be compensated for them through a system of enforceable property rights—not by government appropriation. Noting the failure of 1930s-era proposals for a "market socialism" that promised to combine the best features of government planning and the price system, Smith suggests that bureaucrats and politicians cannot make a pseudo-market for pollution succeed: "If it were so easy to make a utopian tax reform plan work, why is our tax code such an incredible mess? The dreams of planners are bastardized in the political process into that horrible thing we call legislation."

THE DANGER OF GETTING TAX RATES WRONG IS REAL BUT LESS THAN THE STAGGERING COST OF GETTING TRADITIONAL REGULATIONS WRONG.

It is indeed hard to imagine how Congress would ever muster the will to pass a carbon tax that resembles an economist's efficient model more closely than Swiss cheese. The temptation to punch loopholes and special breaks in any measure would be overwhelming. One simulation by Raymond Kopp and Diane DeWitt at Resources for the Future found that a carbon tax of slightly more than $40 a ton would boost household electric bills $163 a year in the Pacific states but $266 a year in the West North Central states (the Dakotas, Nebraska, Kansas, Minnesota, Iowa, Missouri). Would Bob Dole and Richard Gephardt stand still for that?

Similarly, Jorgenson and Wilcoxen find that a tax big enough to cut carbon dioxide emissions 20 percent below 1990 levels would slash coal production in half over two decades, a blow that mining-state legislators would surely resist to the death. "[West Virginia's] Sen. [Robert] Byrd will never let us tax coal at the same rate we tax liquid fuels," asserts the University of Maryland's Schelling.

And yet, for all these objections, pollution taxes deserve a hearing among free-market advocates as a viable "second-best" strategy in the absence of some libertarians' utopia. You don't have to be a green zealot to concede that heavy smog impairs lungs and toxic compounds can kill people. Because individuals who are harmed often cannot pinpoint the specific emissions source causing the damage, and because some harms like cancer are "actuarial," so that the cause of any individual case cannot be traced with certainty, relying on the courts and tort law to protect private-property rights is problematic at best. Barring an intellectual or institutional breakthrough, some form of collective action is needed to control pollution. Once that premise is accepted, pollution taxes in principle are cheaper and more effective in most instances than command-and-control regulations.

The danger of getting tax rates wrong is real enough, but surely less than the staggering and mounting cost of getting traditional regulations wrong. The danger that pollution taxes will simply become another excuse for expanding the size of government is also real enough, but so is the promise of offsetting other, more noxious taxes. The public's enormous resistance to raising gasoline taxes is evidence that pollution levies cannot be imposed without some substantial "give-backs" in the form of tax relief.

Just as the most potent argument against pollution taxes is ultimately political, so too is the strongest argument in their favor: They bring environmental policy "out of the closet" by making explicit just how much environmental protection really costs the economy. "Americans have always been shielded from many of the very real trade-offs involved in establishing environmental goals, programs and standards," notes the Progressive Policy Institute's discussion in *Mandate for Change*. "Conventional regulatory approaches impose costs on industry that are not readily visible (but are partially passed on to consumers). Because neither policy makers nor citizens can see how much they are really paying for given levels of environmental protection, they have little basis for weighing relative risks or alternative policies that might yield more environmental quality for the same investment of public and private resources."

Like any social policy, pollution taxes must be done right. Given the political system's overwhelming predisposition toward "government failure," that may be wishful thinking. But killing the idea is hardly a superior alternative if it just means accepting the status quo by default.

Contributing Editor Jonathan Marshall is economics editor of the San Francisco Chronicle.